

Hon. Mary Jo Heston
Chapter: 11
Location: Telephonic
Hearing Date: November 27, 2019
Hearing Time: 11:30 a.m.
Response Date: At hearing

UNITED STATES BANKRUPTCY COURT
FOR THE WESTERN DISTRICT OF WASHINGTON
AT TACOMA

In re: | NO. 19-43754

PNW HEALTHCARE HOLDINGS, LLC,
et al.,¹

Debtor.

PRELIMINARY OBJECTION OF CANYON
Z, LLC AND CANYON NH, LLC TO FIRST
DAY MOTION FOR INTERIM AND FINAL
ORDERS GRANTING USE OF CASH
COLLATERAL AND SCHEDULING A
FINAL HEARING

Canyon Z, LLC (“Canyon Z”) and Canyon NH, LLC (“Canyon NH” and, together with Canyon Z, the “Canyon Landlords”) file this preliminary objection (the “Objection”) to the *First*

¹ The Debtors in the above-captioned chapter 11 cases, along with the last four digits of each Debtor's federal tax identification number, are: PNW Healthcare Holdings, LLC (9801); North Auburn Health, LLC dba North Auburn Rehabilitation & Health Center (3159); Sequim Health, LLC dba Sequim Health & Rehabilitation (7737); Bremerton Health, LLC dba Bremerton Convalescent & Rehabilitation Center (3188); Crestwood Convalescent-Port Angeles, LLC dba Crestwood Health & Rehabilitation Center (6565); Fir Lane Health-Shelton, LLC dba Fir Lane Health & Rehabilitation Center (7798); Forest Ridge Health-Bremerton, LLC dba Forest Ridge Health & Rehabilitation Center (4019); Meadow Park Health-St Helen, LLC dba Meadow Park Health & Specialty Care Center (9109); Cherrywood Place-Spokane, LLC dba Cherrywood Place (ALF) (7776); Riverside Nursing-Centralia, LLC dba Riverside Nursing & Rehabilitation Center (3792); PNW Master Tenant I, LLC (9824); Franklin Hills Health-Spokane, LLC dba Franklin Hills Health & Rehabilitation Center (1763); Aldercrest Health-Edmonds, LLC dba Aldercrest Health & Rehabilitation Center (3827); PNW Master Tenant II, LLC (5319); Gardens on University-Spokane Valley, LLC dba The Gardens on University (1917); Puget Sound Healthcare-Olympia, LLC dba Puget Sound Healthcare Center (4419); Care Center East Health-Portland, LLC dba Care Center East Health & Specialty Care Center (8950); LaCrosse Health-Coeur d'Alene, LLC dba LaCrosse Health & Rehabilitation Center (8594); Ivy Court-Coeur d'Alene, LLC dba Ivy Court (3197) 75024.

PRELIMINARY OBJECTION OF CANYON Z, LLC AND CANYON NH, LLC TO FIRST DAY MOTION FOR INTERIM AND FINAL ORDERS GRANTING USE OF CASH COLLATERAL AND SCHEDULING A FINAL HEARING - 1

CAIRNCROSS & HEMPELMANN, P.S.
ATTORNEYS AT LAW
524 Second Avenue, Suite 500
Seattle, Washington 98104-2323
office 206 587 0700 fax 206 587 2308

1 *Day Motion for Interim and Final Orders Granting Use of Cash Collateral and Scheduling a Final*
2 *Hearing* [Docket No. 18] (the “Cash Collateral Motion”) filed by the above-captioned debtors and
3 debtors-in-possession (collectively, the “Debtors”). In support of the Objection, the Landlords
4 respectfully state as follows:

5 **PRELIMINARY STATEMENT**

6 1. The Canyon Landlords are disappointed with the way the Debtors have chosen to
7 address defaults with their key creditor constituencies. Good faith engagement often leads to good
8 faith negotiation, which often leads to consensual resolutions that result in a “win-win” for all
9 parties (including, in this case, residents). Unfortunately, the Debtors chose a different path.
10 Despite their admission that their two key creditors – their landlord and their working capital lender
11 – were not taking any aggressive actions,² the Debtors filed freefall bankruptcy cases with
12 absolutely no creditor support, and no clear path to a successful restructuring. Under these
13 circumstances, the Debtors’ requested non-consensual use of cash collateral without any adequate
14 protection in favor of the Canyon Landlords is not justified.
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17 2. The Debtors lease fifteen of their sixteen skilled nursing facilities (collectively,
18 the “Facilities”) from the Canyon Landlords pursuant to two Master Leases (as defined below).³
19 The Debtors are not current in their rental obligations and, as of the Petition Date (defined below),
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22 ² See Declaration of Will Masterson in Support of First Day Motions [Docket No. 5] (the “First Day Declaration”)
23 ¶¶ 28-30. The Debtors state that “MidCap had not taken aggressive action” and “[t]he Canyon Landlords have not
24 sent a formal notice of default.” *Id.*

25 ³ In the First Day Declaration, the Debtors state that they lease all sixteen of their facilities from the Canyon
26 Landlords. See First Day Declaration ¶ 22. However, the facility leased by Debtor North Auburn Health, LLC is no
longer leased from the Canyon Landlords. Upon information and belief, that facility is leased from a third-party
landlord that is not affiliated with the Canyon Landlords. In addition, the Canyon Landlords understand that the
facility formerly operated by the Debtor Care Center East Health-Portland, LLC is no longer in operation.
Currently, however, Care Center East Health-Portland, LLC remains a Subtenant (as defined below) that is subject
to the Master Leases (as defined below).

1 owe more than \$2 million in past due rent.⁴ On December 1, 2019, the Debtors will owe the
2 Canyon Landlords rent in the amount of \$934,792.58, which includes Minimum Rent and
3 Additional Rent (each as defined in the Master Leases).⁵ These, and all other obligations owed to
4 the Canyon Landlords, are secured by security interests in the Debtors' personal property,
5 including cash and receivables.

7 3. Before the Petition Date, after multiple payment and operational defaults, the
8 Canyon Landlords attempted to engage the Debtors constructively to resolve these issues to ensure
9 that the Facilities are operated in a responsible manner so that resident care is not jeopardized.
10 Instead of accepting the Canyon Landlords' invitation to negotiate toward a consensual resolution,
11 the Debtors ignored the Canyon Landlords and filed these cases.

12 4. The Debtors' first day pleadings, including the Cash Collateral Motion, include
13 almost no substantive details about how the Debtors intend to reorganize (other than a conclusory
14 statement that they will), or even why they filed these cases in the first place (other than reference
15 to "reservation of rights" letters sent by the Debtors' working capital lender and assertions by the
16 Canyon Landlords of lease defaults). The Cash Collateral Motion does not mention the Canyon
17 Landlords' security interest in the Debtors' property, let alone propose the adequate protection that
18 the Bankruptcy Code (defined below) requires. The Debtors' proposed budget – which only
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23 ⁴ On a postpetition basis, the Debtors owe the portion of November rent (i.e. the "stub rent") that has accrued, and
24 will accrue, between the Petition Date and the end of November. The Canyon Landlords' right to payment of stub
25 rent is an administrative expense in these cases. The amount of that stub rent (exclusive of any interest or other
26 charges due under the Master Leases) is \$287,602.10.

5 Any statements in this Objection as to the amount of Minimum Rent or Additional Rent (including with respect to
the "stub rent" period) are not intended as a waiver by the Canyon Landlords of the right to payment for any
additional amounts that are due and owing, or that will become due and owing, under the terms of the Master
Leases, including, but not limited to, the right to payment of interest, late charges, and reimbursement of attorneys'
fees and other expenses. The Canyon Landlords expressly reserve the right to assert claims for such amounts.

1 includes three weeks – does not provide for the timely payment of postpetition rent, also something
2 the Bankruptcy Code requires.

3 5. In short, the Debtors have not established any kind of foundation for their proposed
4 non-consensual use of the Canyon Landlords' collateral. Instead, they seemed to have based these
5 unstructured filings on a "hope and a prayer" that they can reorganize. While the Canyon
6 Landlords are committed to engaging in good faith with the Debtors and other key stakeholders to
7 reach a consensus on a sensible path forward, the Canyon Landlords have serious doubts and, thus,
8 object to the Debtors' use of cash collateral on the terms set forth in the Cash Collateral Motion.
9 At a minimum, any use of cash collateral should be conditioned on full and timely rental payments
10 to the Canyon Landlords and adequate protection claims and replacement liens in favor of the
11 Canyon Landlords.

BACKGROUND

A. General Background

6. On November 22, 2019 (the "Petition Date"), each of the Debtors filed a voluntary
petition in this Court for relief under chapter 11 of title 11 of the United States Code, §§ 101 *et
seq.* (the "Bankruptcy Code"). The Debtors continue in possession of their properties and
management of their businesses as debtors in possession pursuant to sections 1107(a) and 1108 of
the Bankruptcy Code. No trustee or examiner has been requested or appointed in these chapter 11
cases.

B. The Canyon Master Leases and Guarantees⁶

6 The descriptions herein of the Master Leases (as defined below) and any other related documents
(collectively, the "Lease Documents") are subject in all respects to the terms of the Lease Documents. To the extent
of any inconsistency in such descriptions and the terms of the Lease Documents, the terms of the Lease Documents
shall control. Moreover, nothing herein is intended as a waiver of any rights of the Canyon Landlords under the
Lease Documents.

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7. (i) Canyon Z, as landlord, (ii) Debtor PNW Master Tenant I, LLC, as master tenant (“Master Tenant I”), and (iii) Debtors Crestwood Convalescent-Port Angeles, LLC, Fir Lane Health-Shelton, LLC, Franklin Hills Health-Spokane, LLC, Gardens on University-Spokane Valley, LLC, Forest Ridge Health-Bremerton, LLC, Puget Sound Healthcare-Olympia, LLC, and Ivy Court-Coeur D’Alene, LLC, as subtenants (each a “Subtenant I” and collectively, the “Subtenants I”) are parties to that certain Master Sublease and Security Agreement dated December 1, 2017 (as may be amended, restated, modified, or supplemented from time to time, “Master Lease I”). Master Lease I covers the Debtors’ HUD Facilities.

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8. (i) Canyon NH, as landlord, (ii) Debtor PNW Master Tenant II, LLC, as master tenant (“Master Tenant II” and together with Master Tenant I, “Master Tenants”), and (iii) Debtors Bremerton Health, LLC, Riverside Nursing-Centralia, LLC, Aldercrest Health-Edmonds, LLC, Care Center East Health-Portland, LLC, Sequim Health, LLC, Cherrywood Place-Spokane, LLC, Meadow Park Health-St Helens, LLC, and Lacrosse Health-Coeur D’Alene, LLC, as subtenants (each a “Subtenant II” and collectively, “Subtenants II” and together with Subtenants I, “Subtenants”) are parties to that certain Master Sublease and Security Agreement dated December 1, 2017 (as may be amended, restated, modified, or supplemented from time to time, “Master Lease II” and together with Master Lease I, the “Master Leases”). Master Lease II covers the Debtors’ non-Hud Facilities.

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9. The Canyon Landlords themselves lease the Facilities, pursuant to master leases (the “Prime Leases”), from property owners (the “Owners”) that are not affiliates of the Canyon Landlords or the Debtors.

1 10. The Master Leases each have initial ten-year terms, starting on November 1, 2017,
2 with the potential for two five-year renewals, all of which is subject to early termination pursuant
3 to the terms of the Master Leases. *See* Master Leases §§ 2.2-2.3.

4 11. Under the terms of the Master Leases, the Debtors are obligated to pay “Minimum
5 Rent,” which includes “Base Rent” plus any other fixed rent due under the Prime Leases. *Id.* §
6 3.1(a). Minimum Rent is paid in advance on the first day of each month. *Id.* The amount of
7 Minimum Rent that will become due on December 1, 2019 is \$763,694.32.

8 12. The Master Leases are “triple net” leases. *See id.* § 3.5. Thus, in addition to
9 Minimum Rent, the Debtors are obligated to pay as “Additional Rent” all other liabilities,
10 obligations, and impositions imposed on, or incurred with respect to, the Facilities. *Id.* § 3.3. For
11 example, Additional Rent includes certain capital expenditures, real estate taxes, and insurance.
12 The amount of Additional Rent that will be due on December 1, 2019 is \$171,098.26.

13 13. Under the terms of the Master Leases, each of the Master Tenants and Subtenants
14 granted to the Canyon Landlords a security interest in the Collateral (as defined in the Master
15 Leases), which includes substantially all of their personal property, including their accounts
16 receivable, and proceeds thereof. *Id.* § 8.2.2.

17 14. Each of the Master Tenants’ obligations under the applicable Master Lease is
18 guaranteed by (i) Debtor PNW Healthcare Holdings, LLC (the “Debtor Guarantor”) and (ii) non-
19 Debtors PNW Healthcare Management, LLC, Dov Jacobs, Miriam Taub, and Jay Taub (“Non-
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1 Debtor Guarantors" and together with the Debtor Guarantor, "Guarantors") pursuant to Guaranty
2 Agreements dated December 1, 2017 (the "Guarantees").⁷

3 **C. Prepetition Defaults and Attempted Negotiations**

4 15. Starting in April 2019, the Debtors began missing, and in some instances making
5 only partial, rent payments. In addition, certain Restricted Operations Defaults (as defined in the
6 Master Leases) occurred with respect to operations at certain of the Facilities. As noted above, as
7 of the Petition Date, the Debtors owed the Canyon Landlords more than \$2 million in unpaid rent.
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9 16. The Canyon Landlords attempted numerous times to engage the Debtors in
10 meaningful discussions with respect to these defaults and operations at the Facilities. Given
11 persistent clinical and regulatory issues, as well as payment defaults under the Master Leases, the
12 Canyon Landlords explored multiple options. To that end, the Canyon Landlords have made
13 multiple proposals to the Debtors that have included the smooth and orderly transition of some or
14 all of the Facilities to a prospective new operator so that continued resident care is not jeopardized.
15 The Canyon Landlords' proposals included a final resolution of obligations of the Debtors and the
16 Guarantors under the Master Leases and Guarantees. Rather than engage meaningfully in a
17 process that accomplishes continued operations for the benefit of residents and a consensual
18 resolution of the Debtors' obligations under the Master Leases, the Debtors ignored the Canyon
19 Landlords and, instead, without even making a counterproposal, filed these cases.
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25 7 The Canyon Landlords reserve, and nothing in this Objection should be deemed a waiver of, any and all
26 rights they have against the Guarantors under the terms of the applicable Guarantees, including, but not limited to,
the right to pursue remedies against the Non-Debtor Guarantors without first obtaining relief from this Court.

1 **D. The Cash Collateral Motion**

2 17. The Cash Collateral Motion provides almost no details on the terms of the Debtors' financing facility with its working capital lender, MidCap Financial ("MidCap"). Proposed adequate protection is almost non-existent, and the proposed cash collateral order (which, among other things, does not even expressly require the Debtors to stick to a budget) is a mere three paragraphs. Although it proposes to use the Canyon Landlords' Collateral without their consent, the Cash Collateral Motion makes no mention of the Canyon Landlords' security interest.

9 18. As to rent, the proposed budget attached to the Cash Collateral Motion (the "Proposed Budget") includes a line item for rent in the amount of \$500,000 in the first week of December and \$317,000 in the second week of December. As noted above, \$934,792.58 in Minimum Rent and Additional Rent will be due on December 1, 2019.

13 **OBJECTIONS AND DISCUSSION**

15 19. The Canyon Landlords are generally skeptical of the Debtors' intentions regarding these cases and their ability to successfully emerge. Among other things, any standalone restructuring requires continued operation of the Facilities, which requires the Debtors to assume the Master Leases (and all rental and other obligations contained therein) and, pursuant to section 365(b)(1)(A) of the Bankruptcy Code, to cure existing defaults, including more than \$2 million of back rent. Moreover, prior to any such assumption, pursuant to section 365(d)(3) of the Bankruptcy Code, the Debtors must timely perform their obligations under the Master Leases. While the Canyon Landlords welcome good faith discussions with the Debtors and other parties regarding a consensual resolution of these cases, the Canyon Landlords expect the Debtors to comply with their obligations to pay rent on time and, if they want to assume the Master Leases, to cure defaults. If the Cash Collateral Motion is any indication, the Debtors are not off to a good

1 start with respect to their ability to comply with Bankruptcy Code requirements. Among other
2 things:⁸

- 3 • The Proposed Budget does not provide for the timely payment of all Minimum Rent
4 and Additional Rent that will be due in the first month of the cases, as required by
5 section 365(d)(3) of the Bankruptcy Code.
- 7 • The Cash Collateral Motion does not provide for adequate protection of the Canyon
8 Landlords' interest in their Collateral, the Master Leases, and their right to the
9 timely payment of rent, as required by section 363(e) of the Bankruptcy Code.

10 **A. The Proposed Budget Does Not Provide for the Timely Payment of Rent**

11 20. Section 365(d)(3) of the Bankruptcy Code requires the Debtors to "*timely* perform
12 all of the obligations of the [Debtors], arising from and after [the Petition Date]" under the Master
13 Leases. 11 U.S.C. § 365(d)(3) (emphasis added). As noted above, the Proposed Budget does not
14 meet this requirement. Although \$934,792.58 of Minimum Rent and Additional Rent will be due
15 on December 1, 2019, the Proposed Budget includes for rent only \$500,000 in the first week of
16 December and \$317,000 in the second week. There is no explanation as to why the Debtors
17 propose to pay rent late or why the amount is insufficient. The failure to adequately address rent
18 is particularly curious in light of the approximately \$2.9 million cash balance that the Debtors
19 show in the Proposed Budget.

20 21. In addition to December rent, the Proposed Budget does not include any mention
21 of the \$287,602.10 of November "stub rent," which is an administrative expense in these cases.

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25 8 The compressed nature of the first day hearing process, coupled with the lack of detail in the Debtors'
26 filings, make a comprehensive list of the problems in the Cash Collateral Motion and proposed relief impractical.
The Canyon Landlords their right to supplement this Objection in advance of any additional interim or final hearings
on the Cash Collateral Motion.

1 *See In re Door to Door Storage, Inc.*, Case No. C17-1385RSM, 2018 WL 1899361, at *2 (W.D.
2 Wash. Apr. 20, 2018) (affirming bankruptcy's courts adoption of "accrual" approach for
3 determining a landlord's administrative expense claim) (citing *In re TreEscape Industries, Inc.*,
4 363 F.3d 994 (9th Cir. 2004)).

5 22. Accordingly, at a minimum the Proposed Budget must permit the Debtors to
6 comply with section 365(d)(3) of the Bankruptcy Code

7 **B. The Debtors Have Not Proposed Adequate Protection for the Canyon Landlords**

8 23. Under section 363(e) of the Bankruptcy Code, the Debtors must provide adequate
9 protection to the Canyon Landlords for any use by the Debtors of the Facilities and the Canyon
10 Landlords' Collateral. Adequate protection is not a discretionary act. *See In re T.M. Sweeney &*
11 *Sons LTL Servs., Inc.*, 131 B.R. 984, 990 (Bankr. N.D. Ill. 1991); *Metromedia Fiber Network*
12 *Servs. v. Lexent, Inc. (In re Metromedia Fiber Network Servs., Inc.)*, 290 B.R. 487, 491 (Bankr.
13 S.D.N.Y. 2003) (adequate protection is not permissive or discretionary). The Debtors bear the
14 burden to show that adequate protection is present. *See* 11 U.S.C. §§ 363(p) (providing that the
15 debtor "has the burden of proof on the issue of adequate protection"); *In re Ernst Home Ctr.*, 209
16 B.R. 955, 965 (Bankr. W.D. Wash. 1997) ("The Debtor has the burden of proving by a
17 preponderance of the evidence that the Member Landlords are adequately protected.").

18 24. Despite the fact that the Debtors have granted the Canyon Landlords a security
19 interest in the Collateral, the Cash Collateral Motion and the proposed order are silent as to any
20 proposed adequate protection in favor of the Canyon Landlords, which violates section 363(e) of
21 the Bankruptcy Code.

22 25. Moreover, in addition to the Canyon Landlords' security interest in the Collateral,
23 the Canyon Landlords have a general interest in the property that it leases to the Debtors. The U.S.
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CAIRNCROSS & HEMPELMANN, P.S.
ATTORNEYS AT LAW
524 Second Avenue, Suite 500
Seattle, Washington 98104-2323
office 206 587 0700 fax 206 587 2308

1 Supreme Court has held that the term “interest” “is the most general term that can be employed to
2 denote a right, claim, title, or legal share in something.” *Russello v. U.S.*, 464 U.S. 16, 21 (1983).
3 The Canyon Landlords certainly have an interest in the Facilities, the Master Leases, and the rents
4 due thereunder for which they are entitled to adequate protection. *See Ernst Home Ctr.*, 209 B.R.
5 at 965 (“[A] landlord is entitled to seek adequate protection of its right to be kept current
6 postpetition under Section 363(e).”); *In re MS Freight Distribution, Inc.*, 172 B.R. 976, 980
7 (Bankr. W.D. Wash. 1994) (“A landlord is free to move at the outset of a case for adequate
8 protection of its right to have obligations under its lease kept current.”); *see also In re P.J. Clarke's
9 Rest. Corp.*, 265 B.R. 392, 404 (Bankr. S.D.N.Y. 2001) (“[A] Landlord's right to timely payment
10 of post-petition rent constitutes an interest in property entitled to adequate protection.”).
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12 26. Section 361 of the Bankruptcy Code provides as follows:
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14 When adequate protection is required under section 362, 363, or 364 of this title of
15 an interest of an entity in property such adequate protection may be provided by—
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17 (1) requiring the trustee to make a cash payment or periodic cash payments
18 to such entity, to the extent that the stay under section 362 of this title, use,
19 sale, or lease under section 363 of this title, or any grant of a lien under
20 section 364 of this title results in a decrease in the value of such entity's
21 interest in such property;

22 (2) providing to such entity an additional or replacement lien to the extent
23 that such stay, use, sale, lease, or grant results in a decrease in the value of
24 such entity's interest in such property; or

25 (3) granting such other relief, other than entitling such entity to
26 compensation allowable under section 503(b)(1) of this title as an
27 administrative expense, as will result in the realization by such entity of the
28 indubitable equivalent of such entity's interest in such property.

29 11 U.S.C. § 361.
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33 PRELIMINARY OBJECTION OF CANYON Z, LLC AND CANYON
34 NH, LLC TO FIRST DAY MOTION FOR INTERIM AND FINAL
35 ORDERS GRANTING USE OF CASH COLLATERAL AND
36 SCHEDULING A FINAL HEARING - 11

37 CAIRNCROSS & HEMPELMANN, P.S.
38 ATTORNEYS AT LAW
39 524 Second Avenue, Suite 500
40 Seattle, Washington 98104-2323
41 office 206 587 0700 fax 206 587 2308

27. The Canyon Landlords submit that, consistent with section 361 of the Bankruptcy Code, they are entitled to adequate protection in the form of (i) cash payments equal to rent,⁹ (ii) replacement liens in Collateral that is acquired by the Debtors after the Petition Date, and (iii) any other adequate protection provided to MidCap with respect to use of the Collateral.

28. Accordingly, to the extent that the Debtors do not adequately protect the Canyon Landlords' right to receive timely rental payments and the Canyon Landlords' security interest in the Collateral, the Cash Collateral Motion should be denied.

RESERVATION OF RIGHTS

29. The Canyon Landlords expressly reserve the right to supplement this Objection or raise additional or further objections at any time prior to the initial or any subsequent hearing on the Cash Collateral Motion.

WHEREFORE, for the reasons set forth herein, the Canyon Landlords respectfully requests that this Court (i) deny the relief requested in the Cash Collateral Motion absent certain modifications raised herein, and (ii) grant such other and further relief as the Court deems just and equitable.

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9 Since the Debtors are already obligated to pay rent under section 365(d)(3), payment of rent as adequate protection is not an additional burden on the Debtors. Moreover, by suggesting that the Debtors should pay rent as a form of adequate protection under sections 361 and 363, the Canyon Landlords are not waiving any rights they have to the timely payment of rent under section 365(d)(3).

PRELIMINARY OBJECTION OF CANYON Z, LLC AND CANYON NH, LLC TO FIRST DAY MOTION FOR INTERIM AND FINAL ORDERS GRANTING USE OF CASH COLLATERAL AND SCHEDULING A FINAL HEARING - 12

CAIRNCROSS & HEMPELMANN, P.S.
ATTORNEYS AT LAW
524 Second Avenue, Suite 500
Seattle, Washington 98104-2323
office 206 587 0700 fax 206 587 2308

1 DATED this 26th day of November, 2019.

2 CAIRNCROSS & HEMPELMANN, P.S.

3

4 /s/ John R. Rizzardi

5 John R. Rizzardi WSBA No. 9388
6 E-mail: jrizzardi@cairncross.com
7 Christopher L. Young WSBA No. 47977
8 E-mail: cyoung@cairncross.com
9 524 Second Avenue, Suite 500
Seattle, WA 98104-2323
Telephone: (206) 587-0700
Facsimile: (206) 587-2308

10 -and-

11

12 GREENBERG TRAURIG, LLP

13 /s/ Nancy A. Peterman

14 Nancy A. Peterman (*pro hac vice pending*)
15 Greenberg Traurig, LLP
16 77 West Wacker Drive, Suite 3100
200 Park Avenue
17 Chicago, Illinois 60601
Telephone: (312) 456-8410
18 Email: PetermanN@gtlaw.com

19 /s/ Eric J. Howe

20 Eric J. Howe (*pro hac vice pending*)
21 Greenberg Traurig, LLP
22 90 South 7th Street, Suite 3500
Minneapolis, Minnesota 55402
Telephone: (612) 259-9716
23 Email: howee@gtlaw.com

24 *Counsel for the Canyon Landlords*

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26 PRELIMINARY OBJECTION OF CANYON Z, LLC AND CANYON
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